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IN THE

Supreme Court of the United States

October Term, 1942.

No. 254.

SECURITIES AND EXCHANGE COMMISSION, *Petitioner*,

v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., *Respondents*.

BRIEF OF CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., IN OPPOSITION TO PETITION FOR CERTIORARI.

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Opinions Below and Jurisdiction.

The citation of the opinions below and the statement of the jurisdiction are correctly given in the petition.

Statement.

The respondents on behalf of whom this brief is filed are seventeen individuals and one corporation who purchased preferred stock in Federal Water Service Corporation

(hereinafter called "Federal") during the period when a plan of reorganization of that company, which was later changed to a plan of merger with Utility Operators Company and Federal Water and Gas Corporation, was under consideration by the Securities and Exchange Commission. The respondents other than Chenery Corporation were officers or directors of Federal or of Utility Operators. Chenery Corporation is a family holding company which had nine stockholders, of whom two, who owned approximately 47 per cent of the stock of Chenery Corporation, were officers or directors of Federal or Utility Operators. All of the purchases were currently reported to the Commission by the purchasers as required by Section 17 of the Public Utility Holding Company Act of 1935. (R. 13, 56, 61).

The Commission refused to permit the preferred stock so purchased by the respondents to participate equally with preferred stock of the same class, and approved the reorganization only on condition that the respondents should surrender their stock to the resulting corporation at cost plus 4 per cent. Upon appeal by the respondents this order was reversed by the United States Court of Appeals for the District of Columbia. (R. 63, 97, 111, 139).

The purchases in question involved approximately 12,000 shares out of a total issue of approximately 160,000 preferred. During the same period more than 130,000 shares of the preferred stock were transferred to other parties. (R. 56-61, 65). The conditions under which the stock was purchased and the issue raised thereby were thus succinctly stated by the Court of Appeals:

> "When the plan was first proposed, members of the Commission's staff objected to the retention of voting power in Federal by its Class B common stock, substantially all of which belonged to Utility Operators Company, which in turn was controlled by officers and directors of Federal. This opposition held in suspense for two and a half years the proposed plan and vari-

ous subsequently suggested amendments.* Notice of the Commission's position in this regard was made public both by the Commission and Federal, and it is agreed was known and understood by stockholders or investors. Realizing that if the Commission persisted in this stand the officers and employees of Federal who had invested in this class of stock would find themselves without either a stake or influence in the company they had helped to create and by which they were employed, Chenery, president of Federal, suggested to many of them that they use what money they could spare to buy preferred stock, stating that he would follow the same course. This resulted in purchases over a period of two and a half to three years on the part of various officers and directors of the corporation. The average purchase of each of the 16 officers and directors, other than Chenery and one Vandenberg was around 130 shares. Chenery, for the account of a family corporation controlled by him, purchased approximately 8,000 shares, of which a lot of 2,700 shares was not a purchase but an exchange for $100,000 of Federal's prior debenture gold bonds, and as to which the other party to the transaction testified that he preferred to have the bonds to the stock 'and today I am very much delighted we made the trade'. The remaining director, Vandenberg, who at the time of the merger—we gather from the record—had ceased to be an officer and director of the corporation, purchased in the open market approximately 1,700 shares.

"The Commission's brief and argument in this court explicitly declare that the conclusion to outlaw this stock is not 'predicated on any finding that petitioners† defrauded or failed to make the fullest disclosure to the stockholders from whom they purchased the shares in question.' On the contrary, the Commission, very properly, admits that the transactions complained of were consummated without 'any ulterior purpose' and equally without any intention to profit personally 'in the consummation of the plan through having traded

* The plan was also delayed by difficulties created by the law of Delaware, which were finally resolved by the decision on January 16, 1940, in *Havender* v. *Federal United Corporation*, 11 A. (2d) 331 (Del. Sup. Ct. 1940). (R. 67).

† Respondents in this Court.

while the proceedings were pending'. We have, therefore, a case in which the facts are agreed, the good faith of petitioners* admitted, and the decision based squarely on the assumption that the purchase of securities of a corporation by its officers or directors for their own account, pending action on an application for approval of a merger, is 'detrimental to the public interest' as that phrase is used in Section 7(d)(6) of the Act." (R. 142).

The Court said further in regard to the purchases:

"* * * it is admitted that there was a full and free disclosure before any purchases were made, the exercise of the utmost good faith throughout, * * *" (R. 146).

"And yet the Commission proposes to annul, not transactions growing out of an abuse of inside information, but transactions as to which both buyer and seller were equally informed of the facts,—not trading designed to take quick profits from short term market fluctuations, but trading for investment by one whose income depended at least in part upon the success of the corporation of which he was an officer." (R. 149).

The Court of Appeals held that no statute, regulation, or rule of common law or equity proscribed this purchase of stock (R. 143), that the statutory phrase "detrimental to the public interest" was never intended to proscribe an investment made under these circumstances (R. 149), and that the action of the Commission constituted retrospective legislation. (R. 150). The order of the Commission was therefore reversed. (R. 150).

* Respondents in this Court.

Argument.

The Question is Not One of Public Importance.

The Commission, as petitioner, has failed to sustain the burden of showing that the question is one of such public importance as would warrant review by certiorari. This burden has been described as follows:

> "The density of litigation dependent upon the ruling in a particular case and its repercussion upon affairs, governmental or economic, are the chief determinants of importance. And these will vary according to time and circumstance." Frankfurter and Fisher, *The Business of the Supreme Court at the October Terms, 1935 and 1936*, 51 Harv. L. Rev. 577, at 597-598 (1938).

Here there is no density of litigation dependent upon the ruling. The Commission says (Petition p. 11):

> "In several cases now pending before it, the Commission is faced with substantially the same issue as was before it in the instant case."

A supporting footnote states that in *Derby Gas and Elec. Corp.*, Holding Company Act Release No. 2875 (July 12, 1941), the Commission made findings similar to those herein, that in *The Middle West Corporation*, Holding Company Act Release No. 3580 (June 5, 1942), the Commission withheld decision because of the decision of the Court of Appeals in the instant case, and that the pendency of at least six other cases involving the issue decided herein has been ascertained from the Commission's files. Whether any of these eight cases involve substantially the same issue as in the instant case is certainly debatable. In one of the cases cited the subsidiary's shares were purchased by its parent corporation and in the other by the predecessor in title of the parent corporation. Neither case involved purchases by officers or directors of either the parent or subsidiary corporations. As the names of the six other cases have not been given we have no means of knowing whether or not

they bear any greater similarity to the pending case than the two cases cited.

Even if the eight cases cited or referred to by the Commission should prove to be in some respect dependent upon the instant case, the number of such cases appears to be relatively small in view of the fact that the Public Utility Holding Company Act has been in operation for approximately seven years. It is also significant that no cases involving the present question have been found in the field of corporate reorganization prior to the entry therein of the Securities and Exchange Commission.

The Commission cannot sustain its allegation of public importance by a mere showing that its decision has been reversed by the Court of Appeals. All cases involving Federal agencies presumably involve the administration and interpretation of Federal statutes, but they are not all so important that they should be reviewed by this Court on certiorari. The mere fact that a court has disagreed with a ruling or interpretation of a Federal agency does not make the case an important one. To illustrate, in each of the following cases in the last two terms of the Supreme Court, a Federal authority petitioned for a writ of certiorari alleging the existence of a question of public importance, but in each case the petition was denied:

OCTOBER TERM, 1941.

No. 987 *Federal Power Commission* v. *Safe Harbor Water Power Corp.*, April 6, 1942, CCA 3rd, jurisdiction of the Federal Power Commission to regulate interstate wholesale rates of a licensed hydroelectric project under Section 20 of Part I of the Federal Power Act. 314 U. S. ——.

No. 1049 *Federal Deposit Insurance Corporation, Receiver*, v. *White et al.*, April 27, 1942, CCA 4th, application of state statute of limitations to a cause of action created by Federal law, and the power of the Comptroller of the Currency and the Federal Deposit Insurance Corporation to take action against directors of an insured national bank who are converting its assets. 315 U. S. ——.

No. 1161 *Helvering, Commissioner of Internal Revenue*, v. *Maytag, Alternate Executor*, and No. 1162 *Helvering, Commissioner of Internal Revenue*, v. *Maytag et al., Executors*, May 25, 1942, CCA 8th, application of the "blockage" theory in the valuation for estate and gift tax purposes of large blocks of stock regularly traded in upon the New York Stock Exchange. 315 U. S. ——.

OCTOBER TERM, 1940.

No. 184 *Helvering, Commissioner of Internal Revenue*, v. *Horseshoe Lease Syndicate*, October 14, 1940, CCA 5th, whether respondent was an "association" within the meaning of Section 1111 (a)(2) of the Revenue Act of 1932 and hence subject to income tax as a corporation. 311 U. S. 666.

No. 249 *Helvering, Commissioner of Internal Revenue*, v. *Rector & Davidson*, October 14, 1940, CCA 5th, on same point as that presented by No. 184, *supra*. 311 U. S. 672.

No. 231 *Helvering, Commissioner of Internal Revenue*, v. *Jennings et al.*, November 18, 1940, CCA 5th, whether under Section 23(g) of the Revenue Act of 1936 taxpayers could offset personal losses from gambling operations against their distributive shares of partnership gains from similar operations. 311 U. S. 704.

No. 764 *Helvering, Commissioner of Internal Revenue*, v. *Cleveland Trust Company, Trustee*, March 17, 1941, CCA 6th, whether respondent was an "association" taxable as a corporation under Section 801 of the Revenue Act of 1934 or was taxable merely as a pure trust under Section 161. 312 U. S. 704.

No. 894 *National Labor Relations Board* v. *E. I. Du Pont De Nemours & Co.*, and No. 895 *National Labor Relations Board* v. *Association of Chemical Employees at Belle Works of E. I. Du Pont De Nemours & Co.*, May 5, 1941, CCA 4th, whether the Board could validly find that Du Pont & Co. violated Section 8 (1) and (2) of the National Labor Relations Act; whether the Board could properly issue a cease-and-desist and disestablishment orders despite the fact that the illegal employee representation schemes had disappeared by

the time of hearing; and whether certain activities of supervisory employees justified the issuance of a cease-and-desist order against the employer. 313 U. S. 571.

The Decision of the Court Below is Clearly Correct.

An officer or director may freely purchase stock of the corporation from its stockholders, provided only that he is not guilty of fraud or misrepresentation. Such is the law of Delaware, where the three corporations involved in this case were organized, *Cahall* v. *Lofland*, 12 Del. Ch. 229, 114 Atl. 224 (1921), aff'd 13 Del. Ch. 384, 118 Atl. 1 (1922); *Dupont* v. *Dupont*, 242 Fed. 98, 256 Fed. 129, cert. denied, 250 U. S. 642, and elsewhere.

> "Indeed, as far as we are able to find, no case has gone to the length of holding a director accountable to a stockholder in the purchase and sale of shares of stock except where fraud or some form of overreaching is shown as the inducing cause of the transaction". (R. 144).

No statute prohibited purchases such as those involved in this case. No regulation of the Commission prohibited such purchases.

If Congress had intended to bring about the result desired by the Commission, a section would have been included in the Public Utility Holding Company Act of 1935, 49 Stat. 803, to provide that officers and directors who purchase stock while a plan of reorganization is under consideration by the Commission shall be required to surrender such stock at cost as a prerequisite to the approval of such a plan. But Congress did not so provide. The Public Utility Holding Company Act of 1935, which is the only statute involved in this proceeding, did deal with purchases of stock by officers and directors, but contained a totally different provision.

After extended hearings on the subject of stock transactions by officers and directors, Congress settled the prob-

lem in Section 17 of the Act. Every officer or director of a registered holding company was required in Section 17(a) to report the securities owned by him in the company or in any subsidiary thereof, and to make monthly reports showing all further purchases and sales. This was obviously for purposes of publicity. Congress further enacted in Section 17(b) that any profit derived from purchases or sales within a holding period of less than six months should inure to the corporation. Section 17(b) states that this was—

> "For the purpose of preventing the unfair use of information which may have been obtained by any such officer or director by reason of his relationship to such registered holding company or any subsidiary thereof * * *"

Senator Fletcher, in reporting the Securities Exchange Act of 1934, from which Section 17 of the Public Utility Holding Company Act of 1935 was bodily taken, said of that section:

> "Such a provision will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others." Senate Report No. 792, 73rd Congress, page 9.

Since the problem of purchases of securities by management was expressly covered by Section 17, no further prohibition or limitation is to be read into the statute through the general language of other sections. Congress clearly did not intend that profits from purchases by management should inure to the corporation, *except* in those specified instances where the profit was realized *within six months* of the date of purchase. The present contention of the Commission that officers and directors should give up stock acquired over a period of two and a half years and held for

investment ignores all tenets of statutory construction. On this point the Court of Appeals said:

> "Clearly, the enactment of Section 17 was intended to restrict a recognized existing right and place a definite and certain limitation on its exercise. But subject to its provisions, officers and directors of a corporation are permitted to deal in its securities. Of this, and of the exercise of the right, day after day, without question, there can be no manner of doubt. And this is just a recognition by Congress of the rule that, while officers and directors are trustees for stockholders as a body with respect to the business and property of the corporation and in the managment of its affairs, they are not trustees—in the sense we are concerned with here—to the individual stockholder, since they have no control over his shares." (R. 145).

The decisions cited by the Commission in support of its contention involve the purchase of trust property by a trustee, fraud or other inequitable conduct, or express provisions of the bankruptcy laws or other statutes. These cases were carefully reviewed and distinguished by the Court of Appeals. (R. 146, 147, 148).

There is no basis in principle or authority for the attempted distinction, as concerns the right of directors to purchase stock, between a corporation which is in the process of reorganization and a corporation for which no plan of reorganization is contemplated. Officers and directors will always know more about the affairs of a corporation than will mere stockholders. This will be so from the organization of the corporation to its final dissolution. It will be so whether the corporation is prosperous or is in failing circumstances, whether it is being reorganized or whether it is not being reorganized.

Until the Commission's action in this case purchase of stock by officers and directors has never been discouraged. On the contrary, a number of states require that directors be stockholders. A criticism often heard in regard to modern corporate practice is that management often does not own enough stock in the enterprises entrusted to it.

The fact that a registered public utility holding company is required to submit a plan to the Commission before the rights of its stockholders can be modified, creates even less basis for the assertion of a duty upon the part of the officers and directors to refrain from purchasing or selling the corporation's stock than would be the case in an ordinary corporate reorganization. The officers and directors of a public utility holding company can only propose a plan for the consideration of the Commission. They cannot even solicit proxies without first obtaining a report upon the plan from the Commission. (Secs. 11(g), 12(e)). The approval of the plan must be by the Commission, and its confirmation must be by the stockholders in accordance with state law, in this case by two-thirds of the stockholders with the right on the part of a dissenting stockholder to have an appraisal and the value of his stock in cash. Delaware Corporation Law, Secs. 59, 61. There is no occasion for the invention of a new principle of corporate law in order to protect these stockholders.

If there is to be any extension of the liability of directors in such situations it should be done by Congress and not by the Commission. Thus the Court of Appeals stated:

> "But, if the Commission's objective is to be attained, it should be only after the *pros* and *cons* have been carefully weighed in their relation, respectively, to the dangers and benefits, and the scales should be controlled by Congress and not by the Commission. In short, all that we hold is that this vital question of policy is one for the Congress and not for the Commission. Until Congress acts to change the standard it has expressly set up in the Act, action by the Commission to expand or enlarge its terms, and to make such expansion or enlargement apply to transactions three years old, is we think, with great deference to the Commission, neither more nor less than retrospective legislation." (R. 149).

Conclusion.

Because the case is not one of public importance and because the decision below is clearly correct, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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